

How to calculate small business working capital



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Small business owners know the challenges of balancing growth with day-to-day financial reality. You've probably faced the stress of making payroll, paying bills or pivoting to a unique opportunity while ensuring you have enough cash on hand. That's why small business working capital is so important. It's the financial fuel that keeps your business running smoothly, allowing you to manage daily costs and navigate unexpected expenses while capitalizing on growth.

[Access to capital](#) is the lifeblood of any small business. Understanding what it is and how to manage it effectively can make a difference between thriving and surviving. Here's what you need to know about small business capital.

What is working capital?

Working capital is a financial metric that measures a company's liquidity and short-term financial health. It's the cash available to cover your daily business needs and short-term financial commitments—think of working capital as your business's financial cushion.

What are short-term expenses?

Short-term expenses range from rent and inventory to marketing campaigns and unexpected repairs. These can quickly add up and strain cash flow.

Expenses can be categorized into fixed, where costs stay relatively constant over a period of time, and variable, where costs fluctuate based on demand.

Common fixed expenses include:

- Rent
- Salaries
- Insurance
- Utility bills
- Loan payments

Common variable expenses include:

- Inventory and raw materials
- Sales commissions
- Shipping costs
- Temporary worker wages
- Marketing expenses

Consider some overlooked expenses in your short-term expenses, too. These include:

- Taxes
- Repairs, equipment or maintenance expenses
- Professional fees (like legal or accounting)
- Travel expenses
- Employee training and development costs

How working capital is calculated

There are two primary formulas used to determine small business working capital. Both involve your current assets and current liabilities. Current assets are the resources you own that you can convert to cash within a year, including:

- Cash in the bank
- Accounts receivable (money owed to you by customers)
- Inventory (products ready to be sold)
- Any short-term investments

Current liabilities are obligations due within a year. Examples include:

- Accounts payable (money you owe vendors or suppliers)
- Short-term loans
- Accrued expenses (unpaid bills like utilities or salaries)

Calculating working capital

The working capital ratio measures your ability to cover your short-term liabilities with your short-term assets. It's calculated as follows:

Working capital ratio = Current assets / Current liabilities

Generally, it may make sense to aim for a working capital ratio of between 1.2 and 2, as this can help show you have enough assets to cover your debts. For example, if your business has \$150,000 in current assets and \$100,000 in current liabilities, your working capital ratio would be 1.5. For every \$1 of current liabilities, you would have \$1.50 in current assets.

Calculating net working capital

Net working capital is the dollar amount of working capital you have available. It's calculated as follows:

Net working capital = Current assets - Current liabilities

Using the same hypothetical example as above, your net working capital would be \$50,000 (\$150,000 in current assets - \$100,000 in current liabilities).

Positive working capital means you have more current assets than current liabilities, indicating financial stability and flexibility. Negative working capital, the opposite, may be a red flag for potential cash flow issues and difficulty meeting short-term obligations.

Step-by-step: how to calculate small business working capital

To calculate your working capital, follow these steps:

1. Determine your current assets by adding up your cash, accounts receivable, inventory and any other assets you have that can be converted to cash within a year.
2. Calculate your current liabilities by adding your accounts payable, short-term loans, accrued expenses and any other obligations due within the next year.
3. To determine your working capital, plug these figures into the working capital ratio formula or the net working capital formula above.

While you can calculate your working capital manually, using accounting software can help streamline this process and reduce the risk of errors. Most accounting programs automatically generate a balance sheet, which has everything you need to calculate your working capital.

Calculating working capital isn't a one-time task. It's an ongoing process that helps you monitor your financial health and make informed decisions about managing your cash flow.

Why do small businesses need working capital?

Anyone who runs a small business isn't a stranger to the day-to-day juggling acts; from meeting payroll to covering rent, there's always a bill or expense. Having enough working capital on hand helps keep your business running, even when faced with unexpected costs or opportunities.

Here's why working capital is essential for small business owners:

Cover day-to-day expenses

Every business has bills to pay. Whether it's employee salaries, rent for your storefront, supplies for your products or utility bills, these recurring expenses are the backbone of your operations. Working capital ensures you can meet these obligations on time, maintain smooth business operations and help build a positive reputation with vendors and employees.

Handle short-term business expenses

Beyond recurring costs, your business will have some short-term expenses that can unexpectedly pop up. Maybe you need to repair equipment, launch a new marketing campaign or buy additional inventory for a busy season. Working capital gives you the flexibility to address these expenses without disrupting your cash flow.

Prepare for unexpected costs

No business is immune from the unexpected. A sudden economic downturn, natural disaster or global pandemic can throw a wrench in your plans. A healthy amount of working capital can act as a safety net, allowing you to weather these storms and keep your business running even with unforeseen challenges.

Take advantage of growth opportunities

Working capital isn't just about staying afloat; it's about pivoting to new opportunities when they arise. If your business has a chance to expand into a new market, develop a new product line or take on a large order, working capital can help you invest, knowing you have the financial resources to support your growth.

Maintain a safety net

Think of working capital as your business's emergency fund. It provides a buffer against unexpected events and financial downturns, giving you peace of mind and the ability to make strategic decisions without the fear of running out of cash. A healthy safety net can be the difference between surviving a hard period and closing your doors.

Small business working capital helps you meet obligations, handle unexpected expenses, invest in growth and weather challenges. By actively managing it, you're setting your business up for long-term success.

Factors affecting working capital needs

Every business is unique, and so are its working capital requirements. Various factors can influence how much working capital a small business needs at any given time. Understanding these factors can help you anticipate needs and make better financial decisions. Some factors to consider:

- Business type: If you're an inventory or service-based business, you'll have different working capital needs to cover goods or operating expenses.
- Operating cycle: Businesses with longer operating cycles often require more working capital to cover expenses, while those with shorter cycles may need less.
- Business goals: Your business goals can impact your needs. If you want to grow and expand, you may need more working capital than if you want to maintain your existing business.
- Seasonality: Some businesses experience fluctuations in sales during different times of the year. Working capital can help serve as a buffer during slower seasons.

Thinking through some of these factors can help you develop strategies to optimize your cash flow and monitor your working capital.

Understanding working capital loans

[Working capital loans](#) are designed to help businesses address short-term cash flow needs. They come in various forms, each with different features, benefits and drawbacks.

Common types of working capital loans

Here are some of the more common types of small business working capital loans:

- Business line of credit: A revolving line of credit gives you funds you can draw from as needed, similar to a credit card. It offers flexibility, but often comes with variable interest rates and other potential fees.
- Short-term loans: These loans provide a lump of cash with a fixed repayment term. They typically have higher interest rates than lines of credit but offer more predictability.
- Term loans: These are a common form of financing for working capital. They must be repaid over a specific period, often a year or less.
- Invoice financing: This option allows you to borrow against outstanding invoices, providing immediate access to cash without waiting for customers to pay.
- Merchant cash advances: These provide quick access to cash in exchange for a percentage of your future credit card sales. They're often easy to qualify for but can have high fees.
- Small Business Administration (SBA) loans: These loans are backed by the [SBA](#) and designed to help small business owners. They often offer competitive rates and terms but may have stricter eligibility requirements.

These loans are available through various sources, including traditional banks, credit unions and online lenders. Each loan has pros and cons, so it's crucial to compare them based on your needs, financial situation and risk tolerance.

The benefits of a working capital loan

A working capital loan can serve as a strategic tool for moving business forward. Here are some common benefits:

Bridge cash flow gaps

Unexpected expenses or seasonal fluctuations can leave your business with a temporary cash shortage. A working capital loan could help bridge that gap, which can help you cover payroll and bills, and maintain operations until your cash flow stabilizes.

Power business growth

Growth requires investment, whether launching a new product line, expanding marketing efforts, or upgrading equipment. A working capital loan may provide the funds you need to seize opportunities and accelerate growth.

Manage seasonal fluctuations

If your business experiences seasonal peaks and valleys, a working capital loan may help manage inventory levels, staffing needs and marketing expenses during busy periods. This helps ensure you have the resources you need to meet demands.

Build business credit

Responsible repayment of a working capital loan can help establish and build a business' credit score. A strong credit history can help open the door to more favorable financing options in the future, which could give you more varied financial flexibility.

Applying for a working capital loan

When applying for a working capital loan, a small business lender may request and require documentation or information including the following.

Generally, the process involves the following steps:

1. Determine your personal and business credit: Your credit history and business score will help determine your creditworthiness. Typically, the higher the scores, the more attractive the loan terms.
2. Decide the loan you need: Review the different kinds of loans available to you, consider their pros and cons and pick the one that best fits your needs.
3. Figure out your funding needs: Working capital loans include more than just the loan amount; you'll need to factor in fees and interest rates. So review your budget and determine the right balance between what you need and what you can afford.
4. Compare lenders: Once you've decided your loan type and amount, shop for lenders. Compare their repayment terms, fees and interest rates. Also, review their application process and customer support ratings.
5. Prepare your documents: Review your lender's application process and gather the documentation required to complete the application. You may also need to provide a business plan.
6. Submit your application: Now you should have everything you need to submit your application.

Preparing for what you need ahead of time will both help streamline the application process and help you determine exactly what you need for your business.

Tips to help manage working capital effectively

Once you've secured the working capital you need, it's critical to manage it effectively to help ensure your business's long-term financial health.

Here are some tips to help you stay on top of your working capital:

- Forecast needs: To help anticipate when you may need additional funds create a cash flow forecast to project your future income and expenses.
- Consider a business advisor: A financial advisor or small business banker can be a valuable resource for helping create a working capital management plan and offer suggestions on financing options.
- Create a repayment plan: If you've taken a working capital loan, create a repayment plan that aligns with your cash flow to ensure you're repaying it on schedule.

Following these tips and proactively managing your working capital can help you navigate potential financial challenges, capitalize on growth opportunities and build a sustainable future for your small business.

Take charge of your financial future

By understanding the nuances of working capital, calculating your needs, and exploring financing options, you're taking a proactive step to help secure your business's financial security.

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